SUBSIDIARY STRATEGY IN A FREE TRADE ENVIRONMENT
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SUBSIDIARY STRATEGY IN A FREE TRADE ENVIRONMENT

The Canada-U.S. Free Trade Agreement is certainly not the only bilateral agreement of its kind ever signed, but it is the only one signed between two nations where one owns half the other's economy. Among Canada's objectives in signing the Agreement was the enhancement of this country's international competitiveness in the growth industries of the future. It was clear at the outset that the signing of the Agreement would not on its own achieve this objective, but would only open the way by providing better access to a large market. Actually achieving greater international competitiveness would require important strategic initiatives to be taken by Canadian-based firms to take advantage of the new opportunities. To a significant degree, these initiatives have to be taken in Canada by subsidiaries of U.S. parents who will in turn not be disinterested bystanders in the process.

Most Canadian subsidiaries view the Free Trade Agreement (FTA) in conjunction with broader globalization pressures facing competitors around the world. These pressures have resulted in the expansion of market share battles beyond Canada and the U.S. to include Western Europe, Japan and much of the Pacific Rim. As a result of these trends, Canadian subsidiary managers interviewed in preparing this report expressed the view that it would be a mistake to view the FTA in isolation. Common remarks included: "free trade is perceived as accelerating the natural pressures of globalization", "the larger issue of globalization is much more critical than the FTA, both in the short and long term" and "free trade is encouraging us to make changes that we would have had to make anyway given increasing levels of international competition".

This opening of international markets has encouraged many subsidiaries to review both where and how they compete. From this review has come the growing realization that the basic strategy that has served subsidiaries well in the past - producing a wide range of parent products for the Canadian market - was dependent for its success on tariff protection. Without tariffs the strategy could not work. And regardless of the FTA, tariffs have been declining under the Tokyo Round of the GATT. The message to the subsidiary is that if it does

not change its strategy it will likely fall victim to its parent's superior cost performance.

While the need for change in subsidiary strategy was fairly well understood, it was not at all clear that the options and their consequences had been well thought through. The general expectation was that subsidiaries would find a way to specialize their product lines, increase their intercorporate trade, and lower their production costs in the process. Left vague were such questions as how the products for specialization were to be chosen and by whom. Also left vague were questions about subsidiary autonomy in a free trade environment. Indeed, specialization and cost reduction can be achieved in several ways, ranging from total integration with the parent (i.e. producing specified models or components in Canada to parent designs and specifications) to independent affiliation (designing and developing products in Canada and marketing them globally for the parent). Between these extremes lie several other points in the continuum. The kind of specialization arrangements subsidiaries ultimately obtain is a matter of considerable economic importance to Canada.

Three factors are likely to influence the outcome. The first has to do with competitive conditions in the industry in which the firm is competing. The second has to do with parent company strategy toward international markets as a whole. And the third has to do with the level of initiative taken by subsidiaries to position themselves effectively within the corporation as a whole. Increasingly, competitive pressures are impacting on parents and subsidiaries in similar ways. The evidence to date, however, suggests that perceptions of these industry pressures differ extensively both between firms in the same industries and between parents and subsidiaries. Because of the role perceptions play in determining strategic initiatives, this report discusses separately the perceptions of the parent from those of its subsidiary.

The view taken in this document is that subsidiary initiative matters; that there are in fact a number of things subsidiary managers can do to influence both strategic direction and competitiveness. Some general suggestions are offered to encourage more positive outcomes for Canada.

Making general suggestions to subsidiaries is always dangerous. Industry conditions vary; parent cultures are different; subsidiary capacities differ in terms of financial, managerial and technological depth. But the timing is right. A lot of important structural changes between U.S. parents and their Canadian subsidiaries are going to be made over the next five years as globalization strategies become a competitive necessity. The hope is that the general suggestions made in this document will be customized and adapted by subsidiary managers in Canada to help them deal more effectively with the strategic negotiations that are bound to arise with their parents.

A. The view from the parent

The strategic attention of U.S. parents is focussed much more on Japan than Canada. Japan has attacked U.S. markets with globalization strategies that have taken the U.S. by storm. Canada by contrast is seen more as a friendly ally than a protagonist. The Canada-U.S. Free Trade Agreement, when it is thought about at all in the U.S., is seen more as a joint defense of North America against the competitive pressures of globalization. The details of the FTA are not widely discussed in U.S. corporations. There has been no national debate about it. The differences between the FTA and Europe 1992 are not widely understood; nor are Canadian worries and fears about the FTA. America seems preoccupied with Japan. For subsidiaries in Canada this presents opportunities as well as problems. Their U.S. parents are unlikely to

1. Take the initiative in discussions about subsidiary strategy under free trade.
2. Respond favourably to arguments based on Canadian sovereignty or government policy.
3. Object to initiatives taken in the subsidiary that are consistent with the overall strategy of the parent.

A number of subsidiary managers interviewed in connection with this study reinforced these points with comments like:

"Our parent company looks to us to do the thinking about Canadian strategy. No one down there is going to do it for us."

"If we don't take the initiative we'll be dead in the water. The U.S. operation will push the wrong projects onto us."

"We have to position ourselves to be the logical choice within the company as a whole for the products we want to specialize in."

"In our company, investment goes where it is most profitable for the enterprise as a whole. Canadian sovereignty doesn't attract projects. In fact, taxes in Canada are an impediment."

"The least efficient plant in the 'empire' becomes the swing plant. It is the one most vulnerable to fluctuations in demand."

From the U.S. perspective then, it is globalization rather than the Free Trade Agreement that is driving strategic thinking. It is useful, therefore, to understand how globalization is affecting U.S. corporate strategy, especially in the area of parent-subsidiary relations.

A1. Globalization

U.S. managers see a number of pressures in the international environment pushing them toward a global rather than a nation state perspective in their strategic thinking. Among the leading pressures are the following:

1. Declining tariffs and the emergence of regional trading blocs are facilitating world trade.
2. Global telecommunications are leading to common consumer tastes.
3. Computer and fax technology are making global coordination easier.
4. Shipping costs have been reduced and transit times cut.
5. The Japanese have succeeded in U.S. and international markets by effectively implementing global strategies.

One of the consequences of these pressures is that world trade has increased rapidly as barriers inhibiting it have been removed. From 1984 to 1988, net world exports climbed 51 percent to the annual level of $U.S. 2.7 trillion. The increase was a staggering 36 percent from 1986 to 1988 alone. By comparison, foreign direct investment flows for this same period averaged well under $U.S. 50 billion, with only modest increases in the volume of investment flows evident. The growth of world exports has also outstripped the growth of world GDP, especially in the seventies and eighties, and especially from the leading industrial countries where the barriers have been lowered the most. Trade once again is challenging foreign investment for

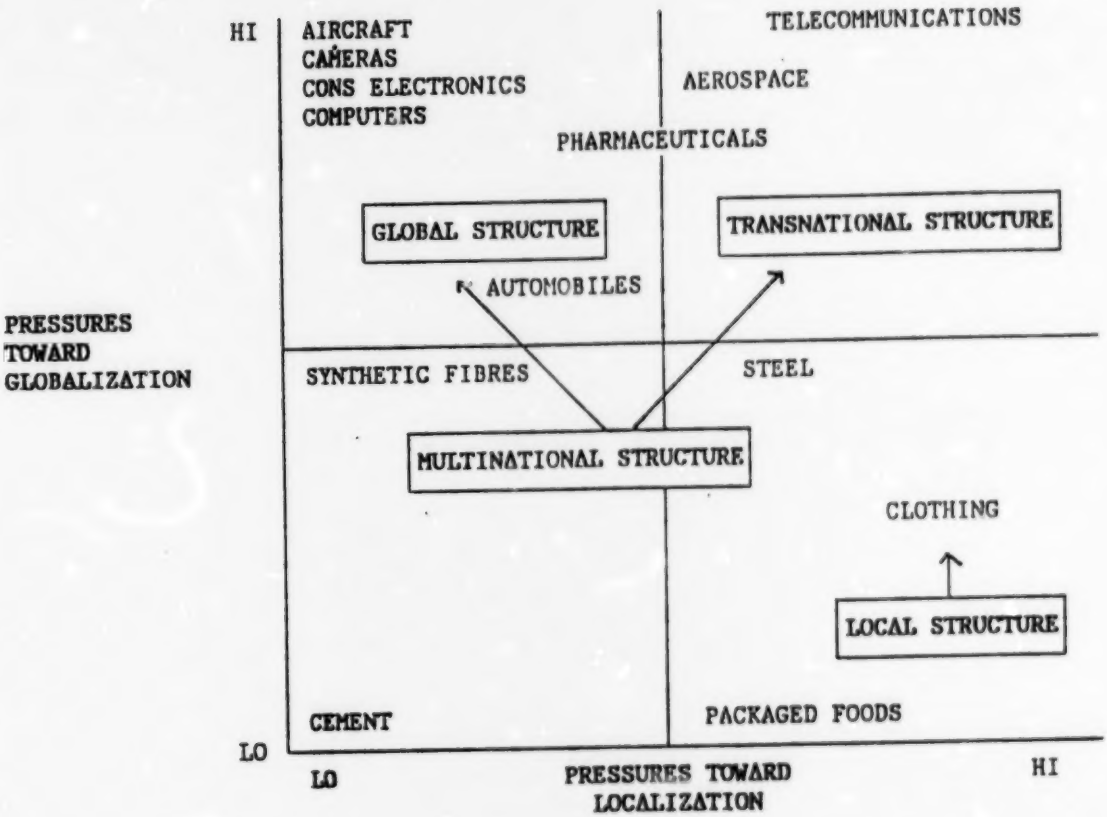
dominance in the global economy. At the same time, there are pressures toward localization which are mitigating globalization strategies especially in certain countries. These include:

1. World trade is still hindered by escalating non-tariff barriers.
2. Foreign exchange problems keep many nations out in the cold.
3. Cultural differences lead to unique consumer preferences.
4. New production technology is reducing the benefits of scale economies.

These pressures suggest that it can be dangerous to think only in terms of "world products" and global marketing strategies. At the same time, global strategies have worked in some industries with some products. For some industries, international trade accounts for a greater share of output than for other more domestic industries. These are the global industries. Competition is truly international. A camera or a stereo, for example, seldom has to be localized to sell in different markets. Packaged foods on the other hand, and some shoes and clothing can be greatly influenced by local tastes and traditions. A representation of industry response to the concurrent pressures toward both globalization and local responsiveness is shown in Figure 1.

FIGURE 1

STRATEGIC CONSEQUENCES OF GLOBALIZATION



Source: This diagram is based on three related papers:

1. Gunnar Hedlund, "The Hypermodern MNC - A Heterarchy?", Human Resource Management, Spring 1986, Vol. 25, No. 1.
2. Christopher A. Bartlett and Sumantra Ghoshal, Organizing for Worldwide Effectiveness: The Transnational Solution", California Management Review, Fall 1988.
3. Herbert Henzler and Wilhelm Rall, "Facing up to the Globalization Challenge", The McKinsey Quarterly, Fall 1986.

As shown in Figure 1, competition is largely local in the bottom two quadrants. Opportunities to globalize competition are minimal. In the case of cement, for example, the industry faces largely undifferentiated worldwide product demand, but obvious transportation inefficiencies eliminate the pressures of international competition. Packaged foods, on the other hand,

may be transportable, but frequently face culturally-specific demand. In the upper quadrants, globalization pressures dominate. The top left quadrant is where local differences are minor and the benefits to globalization are significant. Little benefit can be gained by producing locally. The top right quadrant reflects concurrent demands for both globalization and local responsiveness.

The strategic responses of parent corporations to international competitive pressures are to some extent predetermined by prior decisions to compete in a given industry. The objective is to design a strategy that can be matched to industry opportunities and threats. These kinds of macro decisions are rarely made lightly; rather they typically proceed after an extensive assessment of the strengths and weaknesses of the corporation. Because these capabilities generally emanate from domestic operations, corporate assessments rarely include the abilities of the subsidiaries. To exploit the dominant strengths of the parent, an organization structure is imposed on the entire corporation that is by design consistent with the overall strategy selected. Figure 1 shows the types of organization strategy and structure best designed to accommodate the pressures for globalization and local responsiveness reflected in different industries. These different approaches to corporate strategy and structure are discussed below.

A2. Global strategy and structure

Global corporations conceive and design products for world markets from the outset. Frequently, subsidiaries in key markets have input into product design, but once the parent organization launches a new product the subsidiary's role reverts to that of implementer. Global products are usually marketed to international similarities rather than to cultural differences, and marketing strategies are therefore established as a rule in the parent organization. Products are manufactured wherever in the world the necessary quality standards can be achieved at the lowest cost including transportation to key markets. As a practical matter, large markets attract production because market share is often enhanced by the presence of a production facility. Also host country governments sometimes induce local production through non-tariff barriers to trade, but the classic global strategy is conceived without artificial impediments to the movement of goods.

Under such a strategy, corporate subsidiaries around the world cannot operate with a great deal of autonomy. They are structured by the parent to become an integrated part of a global organization and often play no strategic role at all. If production does take place in a particular subsidiary, it will often be the specialized production of a single model or component for use throughout the corporation. Hence, the design and specification of what is produced is seldom handled by the subsidiary because it is not aimed primarily at the subsidiary's market. In these conditions, coordination between parent and subsidiaries is critical, and is often achieved by tight control mechanisms. Frequently the subsidiary is treated as a cost centre and is run by parent executives on two or three year appointments. The profit centre concept just does not fit the strategy. Global subsidiaries have little strategic autonomy and take few if any initiatives.

A3. Multinational strategy and structure

Multinational corporations develop products for their own market or region, and then offer them for sale or adaptation by their overseas subsidiaries. Subsidiaries have the capacity to absorb parent company technology and adapt the resulting products to local conditions and tastes. In many multinational subsidiaries, that technological capacity grows over time into full-fledged R&D capable of independent product innovation. Traditionally, multinational subsidiaries manufacture products for their own national markets, adapting the parent company product line as required for a specific territory. If specialization is at the heart of global strategies, duplication and autonomy are at the heart of multinational strategies. In the pure multinational model, it is technology and skills which cross national boundaries, not products. It was a model born in an era of high tariff protection.

Under a multinational strategy, the subsidiary or country manager has a great deal of autonomy because the emphasis is on adaptation to local conditions. Multinational subsidiaries are organized by region and country rather than by product line, and are evaluated by profit centre criteria keyed to results rather than obedience. Usually, local nationals are appointed as country managers and turnover is relatively slow. Each subsidiary takes on a character and personality of its own, and formulates its own internal

strategy. The role of country manager and region manager is similar to the role of the parent CEO, except for the more limited geographical sphere of activity. To establish the contrast more clearly the following table summarizes the essential differences between global and multinational organizations.

CONTRASTING GLOBAL AND MULTINATIONAL STRATEGIES

	Global Strategy	Multinational Strategy
product-line	specialized	duplicated
market emphasis	international	national
transfers	product	technology and skills
evaluation mode	cost centre	profit centre
subsidiary role	implement strategy	develop and implement strategy
subsidiary autonomy	low	high
subsidiary management	foreign, short-term	local, long-term

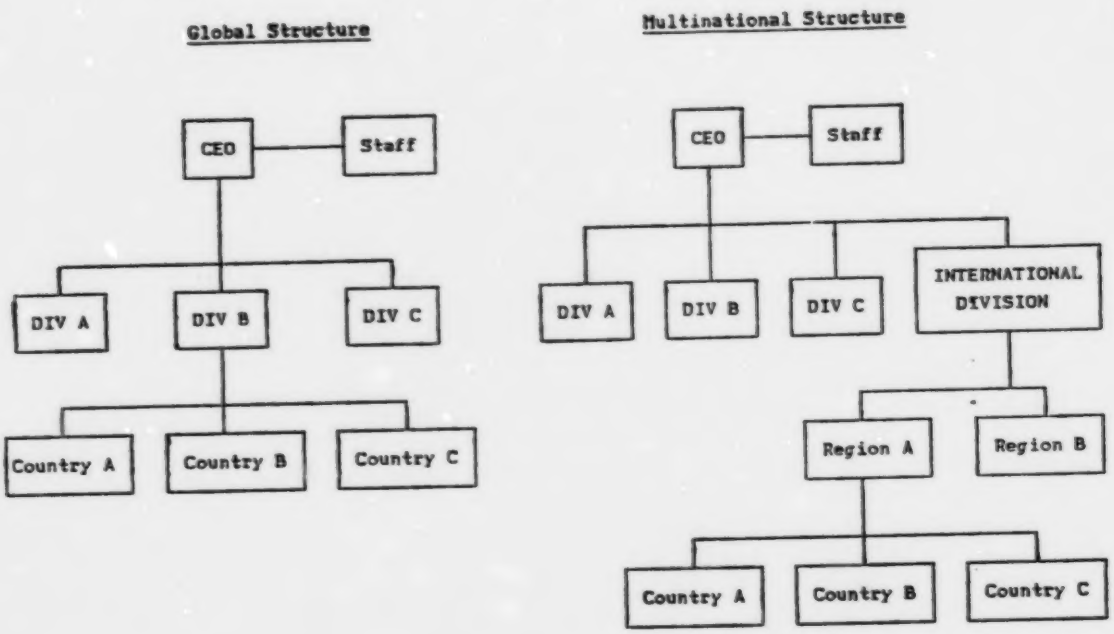
A4. Weaknesses in the global and multinational models

The biggest weakness in the global model is the growing dependence over time of the subsidiaries on the parent and the lack of substantive ideas or initiatives arising in the subsidiaries. Many subsidiary managers also claim that their parents rarely pass responsibility for the highest value-added activities to subsidiaries. Rather, these are maintained in the home country leading to widening dependency of the periphery on the organization's core. The biggest weakness in the multinational model is the difficulty the parent has imposing an overarching strategy on its autonomous subsidiaries and hence obtaining some of the benefits of specialization. Multinational companies remain inherently exposed to low cost global competitors.

These weaknesses with the global and multinational models are enhanced when a company adopts a strategy inconsistent with its industry imperatives and structural design. For example, if a company needs a lot of subsidiary input about local markets because national differences in the industry are important to how the product is designed and sold and it adopts a global structure, then lack of subsidiary initiative becomes a serious impediment. On the other hand, if a company can increase its efficiency a lot by rearranging its production and standardizing needless differences, but has adopted a multinational structure then the autonomy of subsidiary managers

becomes a serious impediment. The organization structures shown in Figure 2 below may make it easier to follow the logic of these arguments.

FIGURE 2



Under the global structure, each product division has global responsibility for its business. It controls its operations in each country along with other divisions. The country manager under a global structure plays an administrative-legal role rather than a strategic one. In fact, many global firms ask the manager of their biggest division to be the country manager, but not to interfere with the operations of the other divisions. The global structure works best in conditions where product knowledge is more vital than market knowledge. Operations in any given country may not be well coordinated and there may be some duplication of selling effort, but each product line gets the maximum attention of someone.

Under the multinational structure, the international division has responsibility for all overseas business. Region and country mangers are responsible for corporate strategy in their regions or countries. They have to become familiar with the products and markets of all the divisions. Their

task is to adapt corporate strategy to local conditions. Knowledge of local politics, markets, suppliers, channels and advertising options constitutes their distinctive competence. They may not give each product the same degree of effort, but will seek out first their strongest competitive opportunities - i.e. where market demand is strongest or competition weakest.

A5. The transnational option

We turn next to the top right quadrant of Figure 1. What should be clear by now is that there are serious potential impediments with both the global and multinational strategies. One gets you greater efficiencies and the other gets you local knowledge. Since there is really no such thing as a perfect organization anyway, one is tempted to suggest simply picking the one closest to the company's product-market thrust and learning to live with the organizational deficiencies. For many firms, that is sound advice. There are, however, a number of firms for whom either deficiency is too costly. Telecommunications is a good illustration. There are powerful pressures toward globalization from high R&D costs and available scale economies, and also powerful pressures toward localization from differences in the systems in place in each country and in the politicization of the industry. Firms facing such challenges sometimes try to capture the benefits of both the global and the multinational structures. So, incidentally, do firms ~~who~~ which have some product divisions that suit the global structure and other product divisions better suited to the multinational structure.

When firms ask, "isn't there some way to have it all?" the transnational organization and the matrix system are the proffered solution. Naturally, they represent a more complex organization to operate, but offer as reward an optimal blend of efficiency and local sensitivity. The matrix organization shares strategic responsibility between product divisions and geographic areas, relying on creative dialogue to bring about the best strategy between a given product and a given market. Because responsibility is shared, the matrix system has led many immature companies into costly strategic paralysis. The system works best in mature organizations with a distinctive corporate culture that helps to establish expectations.

The key elements of the transnational strategy include a two-way flow of ideas and resources, frequent movement of people between units, extensive use of local boards of directors and a global perspective on the part of both parent and subsidiary. The subsidiaries of transnational corporations have a good deal more autonomy than those in global corporations, but still they are an integrated part of a global strategy. Transnational subsidiaries have more control through their boards over the extent of their integration and more knowledge through frequent movement of people of what is going on elsewhere in the corporate world. In the transnational corporation, initiatives arise in subsidiaries as well as parents, and inter-subsidiary linkages are encouraged. The trade-offs between globalization and localization are made in the field by managers committed to the corporation and its competitive objectives, and aware of local market anomalies and differences. The organizational challenge is to ensure a continuous supply of such managers over time.

The reason so many firms are experimenting with complex organizations of this kind is more than just the desire to have the coordination benefits. Other factors are at play. The management of international alliances is facilitated in firms with strong "global" subsidiaries. Access to host government assistance programs and the supply of global managers are not so dependent on head office. Good people join the subsidiaries - because they have interesting enough mandates to attract good people - and end up in other parts of the corporation, including head office. Quality global managers are in short supply and limiting that supply to head office, or to the "home" country exacerbates the shortage.

A6. Transition to globalization

Globalization to most U.S. corporations means a transition from a multinational structure to either a global or a transnational structure. What should guide the transition is the competitive pressures in the industry in question and the organization's strengths and weaknesses. Assessments of the organization should, but often do not, include the strengths and weaknesses of subsidiaries. Indeed, a complete evaluation of strategic alternatives necessitates an assessment of the importance local market knowledge plays in determining competitive success. It is at this stage that subsidiaries can influence parent thinking. The issue here is whether the subsidiary has the

right arguments. For the subsidiary, the importance of taking the initiative with the parent was clear. To quote:

> "The parent organization listens to us because we are successful. Our market share and return on assets are better than theirs."
>
> "The national treatment principle in the FTA will lead to two markets, not one. Canada will remain different from the U.S. We have convinced top management of this, but middle management in the U.S. still hasn't got the message."
>
> "We have kept our best people over the years and we need a structure that allows us to continue to do this. At the same time, we make sure our people are on a lot of U.S. committees. We have to be part of the system."
>
> "Our influence with our parent went downhill when the federal government failed to deliver on a duty remission program they had all but agreed to."
>
> "Taking initiative in strategic issues can be a career-threatening move to a subsidiary manager."

As these comments point out, the subsidiary's ability to influence the parent's approach to international business is limited but real nonetheless. The important criteria for effective influence appear to be.

1. A good track record in the subsidiary - as good as or better than the parent and other subsidiaries around the world. Success was most often measured in terms of profits, costs and quality control.

2. An understanding of the globalization options facing the parent and their potential impact on the subsidiary's ability to hold good people.

3. An understanding of the Free Trade Agreement - specifically that national treatment is different from the harmonization imperatives of Europe 1992.

4. A willingness to get involved at all levels in corporate-wide coordination committees. Subsidiary isolation is not sustainable in an era of globalization.

5. A willingness ultimately to accept that "external realities" - the nature of market demand and product technology - will govern structural relationships division by division.

In other words, subsidiary managers need to have earned the right to be heard, have a good understanding of the globalization issue, a willingness to

accept the constraints of market imperatives, and a willingness to take the career risk of championing a point of view.

B. The view from the subsidiary

Before we cement in place the notion that Canada is the home of the subsidiary and the U.S. the home of the parent, it is worth pointing out that foreign investment and acquisitions in the U.S. rose sharply in the 1980's. Partly due to a weak U.S. dollar and partly to buoyant U.S. markets, there are now a lot of subsidiaries in the U.S. Indeed, during the 1930-1985 period, 39.2% of all foreign direct investment flowed into the U.S.; only 19% emanated from the U.S. While the perspective of this document is Canadian subsidiaries of U.S. parents adjusting to globalization, it is nonetheless useful to bear in mind that Canada is not the only host to subsidiaries. Indeed, the subsidiary perspective is likely to get a more understanding hearing in the U.S. over the next decade.

Globalization is intimidating from a subsidiary perspective. It brings with it shades of the past; a danger that insensitive parent companies will impose ill-fitting products and strategies on increasingly dependent subsidiaries. Subsidiary autonomy is something that has been fought for both by subsidiaries and by host governments. Many host governments in Africa, South America, Eastern Europe and the Far East still insist that foreign investors accept joint venture partners. Part of their purpose is to learn technology and management skills through joint ventures, but the other part is to ensure locally responsive subsidiaries. Many countries that have not insisted on joint ventures have insisted on, or encouraged, foreign subsidiaries to sell some shares to the public. Their purpose has been to increase the reporting requirements of the subsidiary, to make the subsidiary legally accountable to host country shareholders, and to place local nationals on the board of directors to represent the local shareholders and influence subsidiary policies. These ownership devices have made it easier for host governments to accept and live with the enormous amounts of foreign investment flowing into their countries. They provide an important element of political control over a significant portion of the economy that might otherwise escape that control.

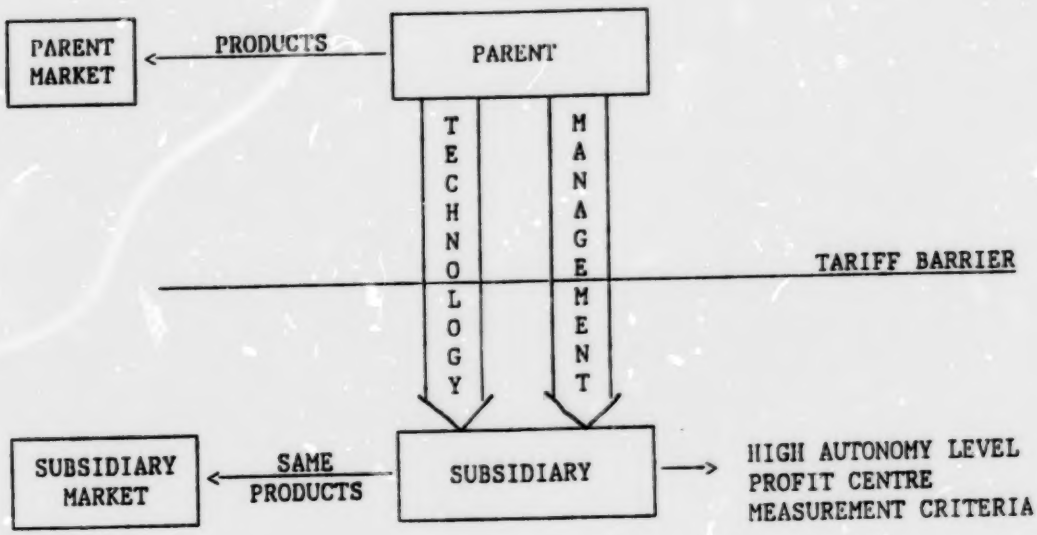
Globalization, however, is challenging this entire approach. Local ownership is an impediment to an integrated global strategy, and many global corporations have been quietly buying back their local shares. Nations that have insisted on joint ventures have been losing their share of foreign investment and many - Mexico being the most recent example - are abandoning their insistence. Increasingly, international cooperation and interdependence under globalization are seen by many as a safer, more rational approach than excessive nation state autonomy. The globalization phenomenon, from this perspective, reflects a more mature political accommodation to the shrinking global village. Interdependence rather than independence, and cooperation rather than confrontation are at the heart of that accommodation. Globalization is therefore an important development and it is important that business manage it effectively. Ultimately, if the journey from independence to interdependence is managed badly it will lead to dependence, and that is an unacceptable destination. A discussion of three alternative subsidiary forms follows.

B1. The multinational subsidiary

Host countries have long used the term "miniature replica" to describe the traditional multinational subsidiary. The term arises because the subsidiary is like a scaled-down version of the parent, in that it produces the same products but in lower volume for a smaller "domestic" market. Tariff barriers keep the markets separated and permit the subsidiary to operate profitably, even though its production costs are higher than the parent company's because of the need to produce multiple products in relatively small volume. Figure 3 attempts to capture these features of a traditional multinational subsidiary.

FIGURE 3

MINIATURE REPLICA STRUCTURE



Given the high level of subsidiary autonomy and the results oriented performance measurement system, one might suppose that host governments would be relatively pleased with the multinational structure. Complaints against it, however, have been numerous. One of the most frequent has been that "miniature replica" subsidiaries do not do R&D; they simply bring in parent technology and adapt it where necessary. With some notable exceptions, the complaint was fairly accurate. Most such subsidiaries could not have afforded to pay for their own R&D and still make a profit on the sales generated in the host market alone. They tended to manufacture many products for a relatively small market - a strategy that can only succeed with imported technology and tariff protection. Another complaint has been that "miniature replica" subsidiaries do not export. Again, this complaint has, with notable exceptions, been fairly accurate. The reason for it has not been parent unwillingness as much as it has been subsidiary inability to export competitively. That inability has been due largely to the subsidiaries' lack of cost competitiveness - they have been high cost producers relative to their parents; and to the subsidiaries' lack of product differentiation - they have used parent technology. There have also been spurious complaints like whether subsidiaries give to charity and whether subsidiary CEO's really have

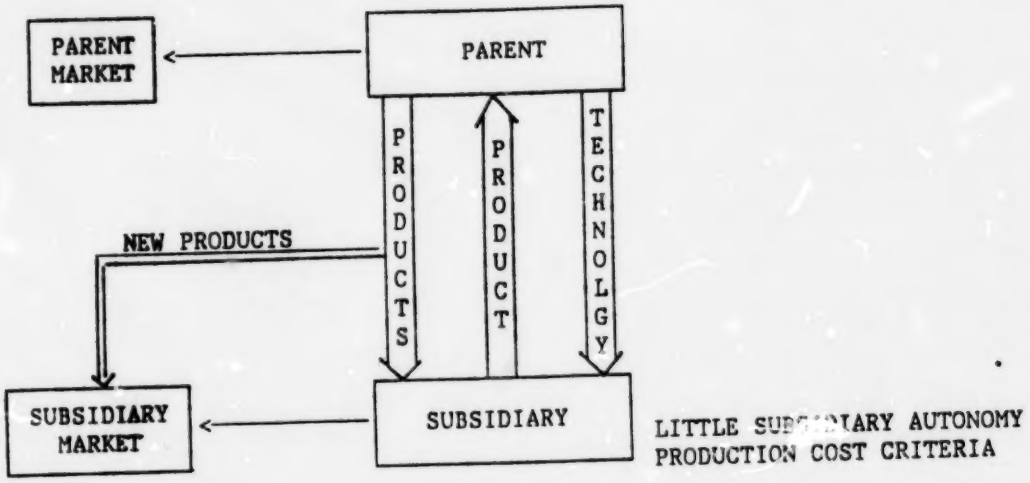
autonomy, but the fundamental concerns in host governments have been that tariff protection has led to an inefficient industrial structure - one that cannot play an effective role in the emerging globalization of business. Hence tariffs are declining so that host countries can transform their industrial structures and make them more competitive. This is the perceived benefit of the FTA. However, if host countries complained about foreign ownership under the miniature replica structure, they are likely to continue to do so under a global structure. The complaints, however, will have a different ring to them.

B2. The rationalized subsidiary

One way to achieve the benefits of globalization is to rationalize production between the parent and the subsidiary. Rationalization implies changing what is manufactured in the subsidiary and therefore what is manufactured in the parent. Instead of producing the full parent company product line in small volume, the subsidiary produces one or two products in large volume for world markets and imports the balance of its needs from the parent. By specializing, the subsidiary achieves competitive costs, but has to spend heavily to transform its production facilities. The parent too is affected. It has to reduce or eliminate its own production of the products the subsidiary is specializing in, and step up its production of the other products to supply the subsidiary. Figure 4 tries to capture these features of a rationalized parent-subsidiary structure.

FIGURE 4

RATIONALIZED STRUCTURE



Products made in the subsidiary under a rationalized structure are made for the parent market as well as the subsidiary market. Consequently, products are frequently made to parent specifications. The parent sees the subsidiary largely as a source of supply. The subsidiary needs parent direction on product specifications because it is not as knowledgeable as the parent about the parent's market. As a rule, in a rationalized structure, the parent handles the marketing in its market and the subsidiary in its. However, the parent will sometimes take new products directly into the subsidiary's market.

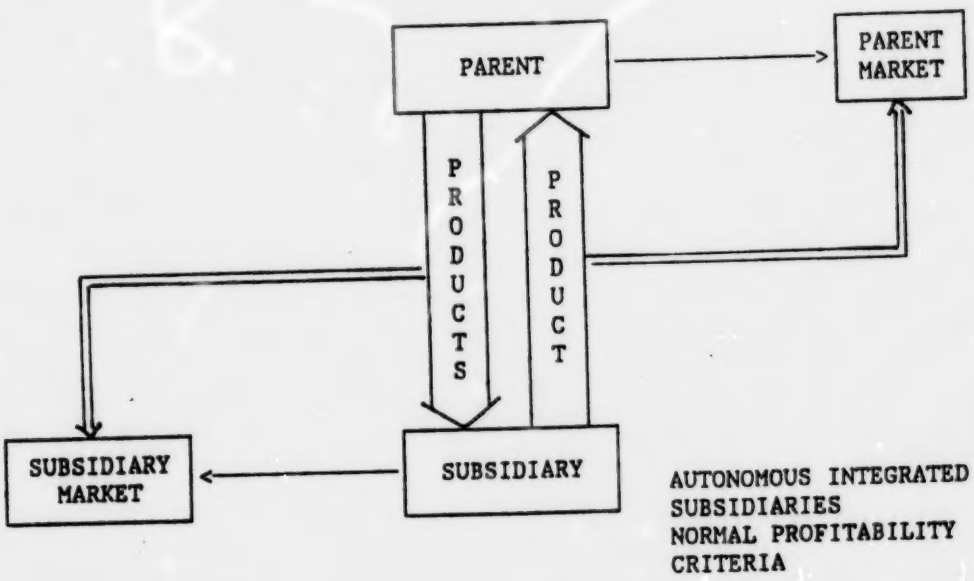
It is difficult for the subsidiary to have any meaningful autonomy under a rationalized structure, and most subsidiary executives resist it for this reason. The structure does, however, correct the subsidiary's lack of cost competitiveness in products bound for the parent. As such, it results in much higher subsidiary exports - and imports. It is a form of adjustment to globalization that achieves the efficiency criteria but at considerable cost to the subsidiary organization.

B3. The world product mandate subsidiary

There is another way to achieve the efficiency benefits of globalization without removing the subsidiary's heart and soul. It is called the world product mandate structure. What it attempts to do is rationalize not just production but all facets of corporate organization. Under the world product mandate approach, the subsidiary still manufactures one or two products for domestic markets, but instead of functioning largely as a factory the subsidiary also handles the related R&D, product renewal and global marketing responsibility for its area of specialization. In other words, the subsidiary functions more like a domestic product division. Figure 5 is designed to capture these features of a world product mandate structure.

FIGURE 5

WORLD PRODUCT MANDATE STRUCTURE



What keeps the subsidiary alive under the world product mandate structure is direct access to world markets in its area of specialization. Without a first hand knowledge of global customer needs, R&D and product renewal activities are of little value in the subsidiary. They have to go together to be effective. Most parents, however, are reluctant to give up control of R&D and product renewal for products which they themselves developed. Sometimes

the key professionals involved do not want to be transferred, and do not see any reason why they should be. As a result, most world product mandate arrangements that do exist arose from subsidiary initiatives in companies whose cultures reward innovative effort.

In order for the world product mandate system to work effectively, subsidiaries need strong senior managers able to function well among parent company senior managers. If a subsidiary becomes a sole or major source of supply and marketing of a specified product area worldwide, its managers soon find themselves operating in the top management committees of the parent organization. The parent has to have confidence in the subsidiary's ability to manage its product market and to function effectively within the overall corporate system. What this means, as a rule, to the subsidiary is using the corporate worldwide sales force when appropriate, linking to the corporate R&D centre when necessary, and keeping the corporation informed of strategic initiatives and forecasts. Many corporations use the technique of offering the worldwide sales force to the subsidiary at a price, often a bargain price. The subsidiary, however, has to develop the marketing strategy, design and pay for the promotion program, and motivate the sales force.

Clearly, the world product mandate system provides for the subsidiary a role that the rationalized system cannot. An economist who concentrates on system-wide production costs may not see the distinction as important, but subsidiary managers do - it was the cutting issue in the Nestlé-Rowntree takeover agreement - and so increasingly do governments eager to retain high value-added activities in the host country.

B4. The problems with specialization

Rationalization and world product mandates are both forms of subsidiary specialization that achieve the efficiency criteria of globalization and work best under minimal or zero tariffs. Both approaches solve the host country problem of subsidiaries not exporting, and the world product mandate system also solves the problem of subsidiaries not doing R&D. Host countries, one might expect, will be pleased. But there is a cost and a number of complications. The cost is that the subsidiary moves from independence to dependence under rationalization and to interdependence under a world product

mandate. The complications, that may well be the host government complaints of tomorrow, are that inter-corporate trade will increase sharply and may not be balanced, and the related transfer prices will become politically sensitive. Under the rationalization system, there will also be some loss of managerial and professional jobs in the subsidiary.

The challenge to subsidiary managers facing globalization pressures is to avoid, if possible, the rationalization of the whole subsidiary. The rationalized subsidiary is the counterpart of the global structure with its accent on efficiency ahead of local adaptiveness. The miniature replica subsidiary, of course, is the counter part of the multinational structure, and is hence the form most under threat from globalization. The world product mandate subsidiary is, more or less, the counterpart of the transnational structure which attempts both efficiency gains and local adaptiveness through strong subsidiaries with life giving mandates. Parent companies will make their choice of structure heavily on the basis of industry pressures and internal assessments on a division by division basis. It is the subsidiary manager's challenge to influence these choices one by one by emphasizing the capacity and depth of the subsidiary relative to the roles it might play. And if a division by division, product by product analysis results in a mixed bag - i.e. between product mandate, rationalization and miniature replica - then learn how to manage a "mixed bag" subsidiary.

In firms like GE, Honeywell and 3M the relationship between parent and subsidiary depends on the division in question. For example, GE Canada manages a modern automated plant located in Bromont, Quebec whose purpose is to manufacture blades and veins for aero-engines produced in the U.S. by GE. There is no possibility of GE Canada getting into the aero-engine business, so that facility is rationalized. The product specifications and design engineering are done of necessity in the U.S. The minimization of costs within quality constraints is a critical task for the Quebec plant. This does not, however, mean that GE Canada as a whole is rationalized. Its appliance division, Camco, with minority Canadian shareholders of its own, is still in the process of working out its preferred strategy, but it is doing it product by product. It is also taking the initiative to position itself to be a lead corporate supplier in selected products where the parent company has not

invested heavily. Honeywell's Canadian operation "earned" a mandate some years ago by redesigning one of the parent company's products to reduce its cost and widen its application. However, until a marketing strategy was developed to guide the international sales force, market share outside Canada did not grow very quickly. The Canadian subsidiary had to develop that marketing strategy and motivate the sales force before the "new" product began to reach its international potential. On the other hand, when 3M built a new tape factory in Canada to serve the North American market as a whole, the Canadian managers were anxious to start marketing in the U.S., but were told their efforts were unnecessary. The U.S. sales force at 3M knew exactly how to market the tape because it was a product they were familiar with. They didn't need marketing help. These few illustrations bring us to the central issue of this document : how to manage effectively the transition to globalization.

C. Managing the transition

The following suggestions for managing the transition process will naturally require a good deal of adaptation from company to company. They are offered to stimulate ideas and possibilities. Indeed, the purpose of setting out the parents' and subsidiaries' perspectives on globalization was to start the creative juices flowing in subsidiaries about how to participate constructively in the process. Some of these management suggestions may, therefore, seem redundant, but sometimes it helps to know what others are doing.

C1. Examine the parent's strategy

At one level the subsidiary should examine the company's product line to determine whether a global or transnational approach suits it best. From Figure 1, it can be seen that the pivotal issue in the choice of structure is whether demand differs between the Canadian and U.S. markets. If it does, it is not hard to make the case that shifting operations to the U.S. will damage market share in Canada over time. Take major appliances as an illustration. Because of sizeable scale economies in production, major appliances would appear to be a prime candidate for rationalization. However, there are several differences between the Canadian and U.S. markets. Canadians are more

fashion-conscious about kitchen appliances and standard U.S. range designs would not capture Canadian consumers. Portable dishwashers are a bigger seller in Canada than in the U.S. as are chest-type freezers. Washing machines may be about to go electronic, in which case the market both sides of the border may be turbulent. The more different the markets, the stronger the case for retaining some production in Canada, and some autonomy in Canadian operations.

At another level, subsidiary managers should examine parent company strengths and weaknesses in order to work out an appropriate subsidiary role. It makes little sense to the company as a whole for its Canadian subsidiary to undertake R&D or product design work in an area where the parent itself has invested heavily. Sometimes, the Canadian operation can take on part of an integrated research task by agreement with the parent. A case in point is Xerox Canada. The parent has established three principal R&D facilities in the world; one is located in Mississauga. This facility has a mandate to carry out basic and applied research involving imaging processing. This includes work in paper, toner, and photoreceptor technology. Much of this work is initiated by Xerox facilities outside Canada. As such, the R&D facility has been rationalized within the entire corporation while taking on few direct product development responsibilities.

More interestingly, the subsidiary can also initiate work on products which the parent has not yet invested in, and develop a special expertise in those products. An example of this is Motorola Canada. The research and development group of Motorola Canada employs about 100 personnel in two Toronto area locations. This group assists the subsidiary's Communications Group which has established a world product mandate for the design, manufacture, and sale of a series of land mobile radio products and systems. The mandate for two-way radios lends itself to a specialty niche in the 25 to 35 watt segment of the industry. Motorola Canada's Product Operations group also controls the mandate for the design, manufacture, and world marketing of computer communications equipment including modems and data multiplexers. Much of this mandate was assumed by Motorola Canada after it was able to prove to the parent that it was able to assert control over product development as well as manufacturing and international sales.

Naturally, such initiatives should be openly discussed with the parent, because if they are successful, they serve as reinforcement to the parent of the subsidiary's competence. If the subsidiary wants to attract and hold good people, project initiatives are important. Without them the technical capacity of the subsidiary soon diminishes.

C2. Examine the subsidiary's strengths and weaknesses

Subsidiary managers should examine their own strengths and weaknesses product by product and compare them to their parents' and to other subsidiaries' around the world. It is important also to communicate one's strengths clearly to the parent company. What they think of you is in some ways more important that what you think of yourself. Major projects are subject to competition within international firms. Canadian subsidiaries find themselves competing with other subsidiaries and sometimes parent divisions for projects. Relative production costs play an important role in the competition, but often the quality reputation and technological depth of the subsidiary are more important. A good example of this is Ingersoll-Rand Canada which is presently involved in bidding for a dramatic expansion of its role in the company's global pump operations. Currently, the parent is supervising the production and marketing of 15 different models of pumps, ostensibly for the U.S. market. Research into expanding this product line to 60 models is ongoing. Two subsidiaries are currently bidding on the right to control the project: Ingersoll-Rand Canada, and Ingersoll-Rand Ireland. Ingersoll-Rand Canada's proposal is to shift all international production control and marketing authority to Canada. International sales will be coordinated out of the Canadian office. The subsidiary is currently receiving positive signals from headquarters which has been impressed with Ingersoll-Rand Canada's cost position and quality reputation vis-a-vis its Irish affiliate. Clearly, the ability to communicate cost, research and development and quality skills is an important tool in the battle to win and retain projects.

Subsidiary managers need to think in terms of positioning themselves to become the "natural leader" in selected products within the corporation. Positioning implies a lot of knowledge about what the subsidiary is good at and what the parent isn't. It implies a gradual build-up of expertise through small studies, mini research projects, pilot production in existing

facilities, and testing market acceptance domestically. The accumulation of expertise and the seizing of well thought out initiatives are at the heart of positioning the subsidiary within the corporation. The process is ongoing. Repositioning in the light of changing patterns of demand and technology is important too. When the process stops the subsidiary starts to die. The challenge is to stay one step ahead of a moving target.

The case of Cyanamid Canada is illustrative in this regard. The parent has operated in this country since 1907 and has current Canadian sales in excess of $300 million. In the early 1980s, the parent undertook a dramatic shift in corporate strategy to reposition itself as a "research oriented biotechnology and specialty chemical company". What followed was a series of divestitures that led to the rationalization and downsizing of much of Cyanamid Canada's operations from a peak 3000 employees to 1400 at the present. However troubling these events were to the subsidiary, local executives clearly believed that much could be done to reverse the situation. The feeling was that the subsidiary's competitive advantage lay in producing smaller run products that required high levels of technological input. Consequently, beginning in 1988, Cyanamid Canada began focusing efforts on reaching out to new technologies in highly specialized fields where it could best apply its unique strengths, resulting in two recent acquisitions of Canadian biotechnology companies. Both acquisitions provide the subsidiary with considerable control over operations and an opportunity to learn skills that will enable it to pursue world product mandates in the future independent of the operational control of its parent.

C3. Determine Canada's strengths

When the battle for projects or product mandates is on, what unique appeals do subsidiary managers in Canada make to support their bids? Is there anything Canadian subsidiaries tend to do cheaper or better than their parents?

> "Our costs for product design and development are about half U.S. costs. They tend to over-engineer things. We have bid successfully on a number of design projects where the products involved are seen as low-volume items."

"We are better than our parent at low-volume production so we can develop products for niche markets in the U.S. that are not attractive enough for large scale U.S. plants."

"Our parent company passes on to us occasional orders from the Far East that require adaptation to local conditions. The orders are attractive to us but not large enough to interest our parent company to do the necessary adaptation."

"We got this project because we wanted it badly and pursued it aggressively. The U.S. division wanted it but didn't really show as much desire. But you have to have the technical capacity to play the game and we had it."

"Our people can be more innovative, creative and flexible than people in the U.S."

Canadian strengths appear to be in product design and low volume production. Flexibility and desire are also mentioned. It is just as well. Taxes are higher in Canada and capital is more costly. It is possible that Canadian subsidiaries might pursue export orders from selected markets themselves rather than wait for a "disinterested" parent to pass them along sporadically.

C4. Manage the integrating mechanisms effectively

Increased integration between parent and subsidiary is an important aspect of any approach to globalization. The combination of complex innovation and marketing differentiation which dominates most world product mandate strategies can only be achieved by tapping into all aspects of the world organization. The importance of linking R&D and marketing functions necessitates vertical linkages throughout the worldwide division and horizontal linkages between sister business units and host country subsidiaries. Consequently, integration can lead to subsidiary dependence or mutual interdependence depending on the parent's strategy and the initiatives of the subsidiary. A variety of integrative mechanisms - including personal contact between managers, interdepartmental transfers and secondments, task forces, and boards of directors - can be used depending on the task requirements at hand. Proper care in encouraging the use of appropriate integrative mechanisms can allow the subsidiary to achieve high levels of integration at multiple levels in the organization without losing

its capacity for independent strategic initiatives. Several examples of the use of these mechanisms are suggested in the following comments.

> "We're at the strategy table all the time. We keep on hammering away about our track record and our plans. We also get a lot of our factory people on to coordinating committees in the U.S. Our travel bill is horrendous at times but the coordination is worth it."
>
> "We have a number of key parent executives on our board, and they understand how to function with local outside directors. They bring a lot of useful input on parent company strategic plans."
>
> "We always touch base with key parent executives on any subsidiary initiatives before we take them up at board level."
>
> "We have a constant stream of expatriates through our head office. Most are Americans who are on their way up. It's good for them because this is a great place to test people. But it also helps us feel more in tune with our parent. We all get a much better perspective of the world."

C5. Develop unique products in subsidiaries

Not all miniature replica subsidiaries have copied the parent's product line entirely. A number have used their accumulated R&D capacity to develop adaptations of parent products or new related products that have become over time areas of distinctive competence for the subsidiary. It is not unusual for a large subsidiary to have 20% of its sales in products its parent does not make. These areas of distinctive competence have sometimes been the basis for world product mandate arrangements which, by and large, have to be earned by the subsidiary. It takes, of course, a good deal of subsidiary initiative to build expertise independent of one's parent, but it is precisely this kind of initiative that pays off in terms of autonomy down the road.

Sometimes the subsidiary's expertise is simply the development of a unique model of a product in the parent's line. It may be a top-of-the-line model. In other cases, the subsidiary obtains its distinctive competence through acquisition ~~of~~ or through licensing ~~in~~ of technology. One of the subsidiaries interviewed had done precisely this, with the parent's agreement of course, but the result was a kind of world mandate for the product line acquired. Again, a lot of subsidiary initiative was involved in the acquisition process. Subsidiaries with a strong tradition of autonomy may wish to look a lot more carefully at positioning themselves through

acquisition or licensing as globalization and the Free Trade Agreement work their way through the economy.

D. Minority ownership in Canadian subsidiaries

Quite a number of Canadian subsidiaries have a degree of local ownership in their shares. A brief review of the 1988 Financial Post top 500 Canadian businesses disclosed that 203 of them were subsidiaries. Of the 203 subsidiaries, 136 were wholly-owned and 67 had minority shareholders. Recently, there have been several buy-outs by parents of the minority shareholders in their Canadian subsidiaries. Nabisco bought out its minority shareholders. ICI bought out the minority shareholders in CIL as did Tate and Lyle in Redpath. And GE recently announced that it was taking GE Canada private with the purchase of its 8 percent public shareholdings. Stockbrokers in Canada publish lists of subsidiaries with traded shares suggesting that impending parent buy-outs make them a good buy. Minority ownership it seems is threatened by globalization. It is not difficult to see the nature of the threat.

The purpose of minority public shareholders from a host country perspective was to increase the accountability of subsidiaries. This was to be achieved through the legal accountability firms have to their shareholders, through the increased reporting requirements associated with going public, and through outsider representation on the subsidiary's board of directors. Underlying these requirements was the view that subsidiaries should be "Canadianized" a bit, and made more responsive to local concerns and opportunities. Globalization in its pure form would challenge the need for these extraneous localization pressures. With tariffs gone, the need for localization of subsidiaries is reduced. Furthermore, globalization leads to greater intercorporate trade, and transfer prices between units with unequal ownership can be troublesome. GE's recent purchase of its minority shareholdings is a case in point. With the increase in globalization, GE now receives more than 35 percent of its profits from international sales. Furthermore, the company has vowed that it will be either number 1 or number 2 in each of the businesses in which it competes or it will get out. This has put considerable pressure on GE Canada, which had been the only subsidiary in the corporation with minority shareholdings. The problem was that

Canadian-responsiveness was not always compatible with corporate objectives. In commenting on the challenges facing the subsidiary, William Blundell, Chairman of GE Canada was quoted in the June 19, 1989 edition of the Globe and Mail as saying:

> "Our strategy over the last five years has been to move away from a miniature GE, which is a polite name for a branch plant operation, to being a player in the global GE team ... [This can be best achieved where we can] add value from a Canadian base."

Spending $118 million to buy out the remaining publicly held equity was viewed as an attempt to centralize control of the subsidiary and thereby facilitate specialization efforts.

The flip-side of globalization is loss of local autonomy - a move away from subsidiary independence - and strong local boards can be an impediment in this process. What is troubling some businesses even more is that globalization has led to a lot of foreign acquisitions and alliances. Parents frequently end up with the Canadian subsidiaries of recently acquired firms which were wholly-owned at the time of acquisition, and they are reluctant to turn them over to their own Canadian subsidiaries where their ownership is reduced by minority shareholders. What is more, when a parent company gets into certain kinds of international alliances, the rights of its subsidiaries to share in the benefits require separate agreements.

On a number of dimensions, it is clear that minority public shareholdings in subsidiaries constitute an impediment to the globalization process. Many firms are going to buy out their minority shareholders unless there is some economic incentive to keep them. One subsidiary executive put it this way:

> "I think all subsidiaries should have local ownership. It makes the company more transparent and keeps it out of trouble in the long run. Canada should have economic incentives in place to encourage more local ownership in subsidiaries."

The arguments in favour of local ownership are the same as the arguments favouring local autonomy in subsidiaries, and local autonomy is clearly one of the casualties of globalization. However, the transnational approach with its accent on maintaining strong subsidiaries with significant mandates may not be

entirely at odds with globalization. Subsidiaries with strong local boards have an easier time attracting and holding good people, and an easier time taking initiatives and developing distinctive competences. Without local ownership, it is too easy to clone obedient subsidiaries. In life, parents let go of their children as they mature, otherwise the relationship between them becomes strained. In business, parents run a similar risk with excessively dependent subsidiaries.

The real question is whether subsidiaries with minority shareholders can make the journey from independence to interdependence. Even transnational subsidiaries are more integrated than multinational subsidiaries. How might the integration process be managed? What could be learned from subsidiaries with minority interest shareholders who have managed the integration process effectively? There may be merit in examining in depth the way local boards are used in different corporations in order to answer more clearly whether local ownership is necessarily an impediment to globalization, and if it isn't what procedures have to be adopted by subsidiaries to manage the transition to integration.

CONCLUSIONS

This report has attempted to review the strategic alternatives facing Canadian subsidiaries pursuant to the passage of the Free Trade Agreement. What has become clear from interviews and related research is that competitive industry pressures, the strategies of parents and the initiatives of Canadian subsidiaries will have a dramatic effect on the ability of Canadian subsidiaries to remain competitive into the 1990s. In this context, the FTA can be viewed as a force that will accelerate Canadian business exposure to the natural pressures of globalization that face competitors around the world.

A number of suggestions have been made to help subsidiaries manage the transition to globalization more effectively. Success seems to require a subtle blend of initiative and integration. While transition strategies have to take account of the parent's own direction, they can range as far afield as subsidiary acquisitions, innovations and exports. Initiative rests in the subsidiary, but it must be constrained by the integration imperatives of globalization. Some of the finest artistic achievements have arisen because

of constraints imposed by existing conditions. The timing of these initiatives is critical. As parents move to rationalize more and more operations, most Canadian subsidiaries will have little time to develop specialized capacities and convincingly communicate these abilities to their parents. Action must be swift and designed to exploit existing competitive advantages. Clearly, there is ample room in present economic conditions for some very imaginative though not necessarily audacious strategic initiatives on the part of Canadian subsidiaries.